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**JOINT SESSION OF THE UNIDROIT GENERAL
ASSEMBLY AND THE UNIDROIT COMMITTEE
OF GOVERNMENTAL EXPERTS
FOR THE FINALISATION AND ADOPTION OF
A DRAFT MODEL LAW ON LEASING
Rome, 10/13 November 2008**

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DRAFT MODEL LAW ON LEASING

**as reviewed and authorised for transmission to Governments and Organisations, for
finalisation and adoption, by the UNIDROIT Governing Council, at its 87th session, held in
Rome from 21 to 23 April 2008:**

COMMENTS

submitted by Governments and Organisations

INTRODUCTION

Further to the comments on the draft model law on leasing transmitted to Governments and Organisations, pursuant to a decision taken by the UNIDROIT Governing Council at its 87th session, held in Rome from 21 to 23 April 2008, for finalisation and adoption by a Joint Session of the UNIDROIT General Assembly and the UNIDROIT Committee of governmental experts (hereinafter referred to as *the draft model law*) contained in J.S. Leasing/W.P. 5, representing the comments which had reached the UNIDROIT Secretariat by 20 October 2008, the UNIDROIT Secretariat has subsequently received additional comments from the Government of the United States of America and from the Equipment Leasing & Finance Association of America. These additional comments are reproduced hereunder.

COMMENTS SUBMITTED BY GOVERNMENTS

United States of America

Re: Article 2 - Definitions

Treatment of software in definitions of "Asset" and "Lease"

At the last session in Oman, two States requested clarification as to whether the preliminary draft's definitions of "asset" and "lease" were intended to include leases of software and other intellectual property. The distinguished member of the UNIDROIT Advisory Board for the preparation of a model law on leasing, Mr Rafael Castillo-Triana, in a letter of 15 October 2008, suggests that the commentary to the future model law should not decide the question of that future model law's applicability to intellectual property but rather the commentary should make clear that the applicability of the future model law to software leasing is dependent upon local law. The United States agrees with that suggestion. This clarification is important because the terms relate to the scope provision of the draft model law .

The United States suggests that the commentary include the following:

“Under the model law’s definitions, in order to qualify as a lease, the transaction must be one in which the lessor “grants a right to possession and use of the asset” The model law does not define possession, thereby leaving the definition of that concept to local law. In States in which the term “possession” refers to actual physical possession of a tangible asset, “possession” cannot refer to intangible assets such as intellectual property. In that case, the model law would not apply to transactions in which intellectual property is “leased.” In States in which “possession” has a broader definition, including concepts such as control or constructive possession, the model law might apply to intangible assets”.

Inclusion of re-leases in definition of financial lease

Both Mr Castillo-Triana in his letter of 15 October 2008 and the Equipment Leasing & Finance Association of America (“E.L.F.A.”) in their comments on the draft model law¹ recommend that the definition of “financial lease” in Article 2 be amended to include re-leases of assets that were initially subject to a financial lease. Thus, the policies that apply to the original financial lease would apply equally to the re-lease. The United States supports that recommendation.

The United States suggests that the definition of a financial lease be revised to state as follows:

“Financial lease means a lease, with or without an option to purchase, that includes the following characteristics:

(a) either:

(i) the lessee specifies the asset and selects the supplier and the lessor acquires the asset or the right to possession and use of the asset in connection with the lease and the supplier has knowledge of that fact; or

(ii) the asset was previously leased in a financial lease and the lessor does not manufacture or supply the asset; and

(b) the rentals or other funds payable under the leasing agreement take into account or do not take into account the amortisation of the whole or a substantial part of the investment of the lessor.”

Re: the question of the exclusion of large aircraft in the absence of “opt-in” under Article 3 - Other laws

The United States supports the joint proposal by the UNIDROIT Secretariat and the Aviation Working Group regarding the application of the draft model law to aircraft transactions. After extensive consultation with the aviation industry and a review of the laws and practices applicable to leasing and sales in that sector, we believe that the draft model law is generally inappropriate in the aviation context and, in its current form, would not produce economic benefit. Accordingly, and in order to avoid complex revisions to the text, the United States supports the joint proposal for inclusion of a provision excluding applicability of the draft model law to leases of aircraft equipment covered by the Cape Town Convention and Annex, unless the parties to the lease choose to “opt in” to applicability of the draft model law. We also find the specific wording in the joint proposal to be satisfactory.

¹ Cf. pp. 4-7, *infra*.

Re: the question of freedom of contract under Article 7 - Lessee under financial lease as beneficiary of supply agreement

Consistent with the comments of Mr Castillo-Triana in his letter of 15 October 2008 and those of E.L.F.A. in their comments, the United States has serious concerns about sub-paragraph 1(c) of Article 7 concerning mandatory duties of the lessor to take steps to assist the lessee in enforcing the duties of the supplier under a financial lease. Consistent with the comments of Mr Castillo-Triana, the United States would limit the duty of the lessor to a requirement to execute documents and take such other steps necessary to enable the lessee to enforce its rights.

Moreover, the role of the lessor in a financial lease is to supply financing. The lessor does not have a role in selecting or manufacturing the assets. The United States believes that in certain circumstances precluding the parties to a financial lease from derogating from or varying the effects of Article 7 may force a potential financial lessor to choose between incurring inappropriate risks or declining to enter into the lease agreement. This would probably preclude transactions that would be mutually beneficial to both lessors and lessees. For this reason, the United States supports the deletion of Article 7(3), which states, "The parties may not derogate from or vary the effect of the provisions of paragraphs 1 and 2."

Re: the question of the limitation of liability of the lessor/owner under Article 9 - Limitation of liability of the lessor

Consistent with the suggestions of Mr Castillo-Triana in his letter of 15 October 2008 and those of E.L.F.A. in their comments, the United States believes that Article 9 should state the following:

"In a financial lease, the lessor shall not, in its capacity of lessor or owner, be liable to the lessee or third parties for death, personal injury or damage to property caused by the asset or the use of the asset".

The United States had believed that the preclusion of liability of a financial lessor in its "capacity as lessor" precluded liability of the lessor as owner of the leased asset because one usually cannot be a lessor without also being an owner. However, the most recent draft comment on the draft model law (30 June 2008) states that, "In order that the future model law not conflict with existing domestic laws regarding products liability, Article 9 does not affect the lessor's liability in any other capacities, such as that of owner."

This interpretation of Article 9 would be counterproductive to the fundamental purpose of the proposed model law (i.e. to promote the development and benefits of financial leasing in developing countries). In a financial lease, the lessor is acting solely in a financial capacity, merely providing the capital to finance the lessee's choice of equipment and supplier. If the financial lessor could be held liable for situations such as product defects, manufacturer negligence or lessee actions and choices, then the risks and cost of financial leases could rise significantly. As a result of these potential risks, the availability of financial leases could diminish, depriving businesses in those countries of the benefits of financial leases for many important types of product.

Accordingly, the United States believes that Article 9 should be clarified to state that the lessor in a financial lease has no liability either as the lessor or owner.

Re: the question of the contractual waiver of defences under Article 15 - Transfer of rights and duties

The United States supports the retention of the bracketed text in the current draft of Article 15(1)(a)(ii) (“[other than those arising from the incapacity of the lessee].” Article 15 is drawn from Article 19 of the United Nations Convention on the Assignment of Receivables in International Trade (hereinafter referred to as *the Assignments Convention*) and Recommendation 49 of the 2008 UNCITRAL Legislative Guide on Secured Transactions (hereinafter referred to as *the Legislative Guide*). Both instruments permit an obligor to agree not to assert defences other than those arising from incapacity against a transferee of the obligation.

Use of the term “incapacity” in the Assignments Convention and the Legislative Guide is intended to cover circumstances such as mental incompetence and lack of corporate capacity to do business. Its existence and effect is left to the law of each State. If, under the law of a given State, the effect is to render the obligation of the instrument entirely null and void, then the defence may be asserted against a transferee of the lessor’s rights under a leasing agreement.

Re: the question of freedom of contract under Article 16 - Warranty of quiet possession

Consistent with the comments of Mr Castillo-Triana in his letter of 15 October 2008 and those of E.L.F.A. in their comments, the United States questions whether Article 16(1)(a) and (2) should be exceptions to the general rule of freedom of contract. Although the limitations on freedom of contract are intended as a mechanism for protecting lessees, there are several circumstances in which the inability to allocate to a lessee the risk of a superior title or right to an asset will prevent a lessor from entering into a transaction that would benefit the lessee.

For example, if the leased goods are sub-leased, and the lessee-sub-lessor cannot by contract derogate from or vary the sub-lessee’s rights with regard to the warranties created by Article 16, the sub-lessor and sub-lessee will not be able to allocate between themselves the risks associated with a breach of those warranties.

As another example, a lessor may wish to acquire assets in bulk to decrease costs. The savings may then be passed on to the lessee. However, there is a risk that a creditor of the seller will assert a claim to the assets under a bulk sales law. The lessor should be able to allocate this risk to the lessee by contract.

The United States generally supports wide application of the principle of freedom of contract and urges that Article 16 not constitute an exception to that principle. As noted above, the United States is concerned that the decision to limit freedom of contract may in this instance have unintended negative consequences for lessees.

COMMENTS SUBMITTED BY ORGANISATIONS

Equipment Leasing & Finance Association of America

The Equipment Leasing and Finance Association (E.L.F.A.) is the trade association representing financial services companies and manufacturers engaged in financing the utilisation and investment of/in capital goods. E.L.F.A. members are the driving force behind the growth in the \$650 billion commercial equipment finance market and contribute to capital formation in the U.S. and abroad. Its over 750 members include independent and captive leasing and finance companies, banks, financial services corporations, broker/packageers and investment banks, as well as service providers.

E.L.F.A. has been involved in the model law project from its inception and sent representatives to every meeting of the UNIDROIT Advisory Board formed by UNIDROIT to draw up a preliminary draft model law. E.L.F.A. members also attended the second session of the Committee of governmental experts, held in Muscat from 6 to 9 April 2008. E.L.F.A. has often submitted comments and suggestions to improve the draft model law and has co-operated with other Organisations and Governments to reach a consensus as to a number of important issues. In general, E.L.F.A. is very pleased with the progress made in the draft model law. These comments will address the remaining concerns we have with the draft model law. With the exception of one comment that addresses a text change made during the Muscat session to Article 9, the issues discussed herein have been raised by E.L.F.A. in its earlier comments.¹

Re: the question of the definition of financial lease under Article 2 - Definitions

E.L.F.A. commends UNIDROIT for its decision to broaden the scope of the definition of financial lease to include both partial and full pay-out leases. In our view, the success of the future model law is very much dependent on whether it promotes financial leases, by which we mean a lease where the lessor is only serving as a funding source and the lessee selects the supplier of the leased goods and the leased goods themselves. By broadening the scope of this definition, UNIDROIT has gone far towards its goal of creating a law that "should be as broad as possible in its substantive sphere of application so as not only to encompass the present-day needs of developing countries and transition economies but also to envisage likely trends in the development of such markets."

Our remaining issue with the definition of financial lease relates to re-leases of goods. Although there should be no doubt that clause (b) of the definition, which states, in part, that "the lessor acquires the asset or the right to possession and use of the asset in connection with a lease" permits a re-lease to be a financial lease, we request that for an issue this important, the official commentary make clear that a re-lease of goods, whether to the original lessee or to a new lessee, can constitute a financial lease. Resolving any lingering doubt in this respect will be of great help to lessees searching for lower-cost lease options and will enable the leasing industry to provide lease options to lessees that would otherwise be unable to bear the lease costs of new goods. Allowing for such re-leases promotes greater efficiencies, as lessors are able to maximise the value of the goods they have in their inventories and they would not be saddled with the costs of disposing of otherwise useful goods, because they cannot lease them again under a financial lease. Conversely, allowing for re-leases will encourage lessors to invest in goods in the local leasing market, as they will not be as concerned about disposing of the goods upon the expiration or termination of the original lease. Inevitably, this should lower the costs to lessees under these subsequent leases. Furthermore, the fact that a lessor acquired goods in connection with a prior lease is immaterial to the essential elements of a financial lease; the lessee has selected the goods and the supplier and the lessee and lessor are looking to the supplier and not the lessor with respect to goods-related representations, warranties and covenants.

Re: Article 7 - Lessee under financial lease as beneficiary of supply agreement

E.L.F.A. continues to recommend that Article 7 not be one of the mandatory provisions and we call for the deletion of Article 7(3), which states, "The parties may not derogate from or vary the effect of the provisions of paragraphs 1 and 2."

Article 7 addresses the rights and duties of the lessor and lessee to the financial lease vis-à-vis the supplier and the supply agreement. However, Article 7 applies only if the lessee is not a party to the supply agreement. As the fundamental characteristic of a financial lease is that the

¹ For example, we direct your attention to the E.L.F.A. memorandum to UNIDROIT, dated 27 September 2006, for a prior discussion of issues raised herein.

lessee picks the supplier, we see no rationale for the imposition on the lessor of mandatory duties in connection with a supplier that the lessee knew or should have known would not agree to allow the lessee to be a party to the supply agreement. If being a party to the supply agreement were important to the lessee, it could make that a condition of any dealings with the supplier. If the lessee does not consider being a party to the supply agreement an essential component of its selection of a supplier or accepted the supplier although not able to be a party to the supply agreement, that decision reflects the lessee's business judgment of the risks arising therefrom. In either case, there is no tenable business or legal argument that requires that these risks be passed through to the lessor. By maintaining the mandatory nature of Article 7, the draft model law encourages lessees to ignore or minimise the important question of whether it ought to be a party to the supply agreement and, as explained below, by doing so, the lessee is able to make the lessor responsible for duties under the supply agreement that properly ought to be performed by the party in possession of the leased goods. Furthermore, many lessors may not be willing to assume this risk. It is very likely, should Article 7 remain unchanged, that lessors may not agree to enter into a financial lease unless the lessee is a party to the supply agreement. This logical position by lessors will, in the best case, delay fundings, as lessees have to go back to the supplier to renegotiate the supply agreement, and, in the worst case, may prevent lessees from obtaining the lease financing they were seeking.

We have two concerns with the substantive provisions of Article 7. Article 7(1)(b) states that no duty is imposed on the lessee under the supply agreement merely because Article 7(1)(a) provides the duties of the supplier under the supply agreement are owed to the lessee even though the lessee is not a party to the supply agreement. We are concerned that Article 7(1)(b) will be read to excuse a lessee from the performance of those obligations under the supply agreement that it ought to assume as the party in possession of the leased goods. Any reading that would impose those kinds of duty on the lessor would be contrary to existing business practices, inefficient and prone to failure. For example, most supply agreements provide that the supplier is only obligated to honour its warranties contained therein if the leased goods are being maintained as provided in the supply agreement. We fail to see why the draft model law would require a lessor to be responsible for those maintenance obligations, since it does not have possession of the leased goods and, in the vast majority of cases, lessees to financial leases are willing under current practices to assume all maintenance obligations for the leased goods, and especially since, as mentioned above, it was the lessee's decision not to be a party to the supply agreement or to transact business with a supplier that would not consent to the lessee being a party to the supply agreement. Likewise, the supply agreement may require that notices be provided to the supplier upon the happening of certain events (such as a malfunction of the leased goods that is covered by a warranty) and to require the lessor to give this notice even though it does not possess the goods and may never learn about the malfunction is likely to result in non-compliance by lessor with the notice provision.

We are also concerned about Article 7(1)(c). Article 7(1)(c) only applies if the jurisdiction whose laws govern enforcement of the supply agreement has not adopted the future model law since, in any jurisdiction that has adopted the future model law, Article 7(1)(a) would give the lessee the right to enforce the supply agreement. As we stated above, the lessee has the right to select the supplier and, in doing so, the lessee is able to influence which law will govern the supply agreement. If the lessee is willing to use a supply agreement that is governed by a law that may not give full effect to the lessee's rights under Article 7(1)(a), there is no business or legal reason why the lessor has to bear the consequences of the lessee's decision. Article 7(1)(c) is further objectionable because it fails to limit the lessor's obligations arising thereunder. The trigger to a lessor's duties under Article 7(1)(c) is the absence of privity between the lessee and the supplier. If that is the case, the lessor's obligations should be limited to taking those reasonable steps that would put the lessee in the same approximate position it would have been in vis-à-vis the supplier had such privity existed. Unfortunately, the text as drafted, which states that "the lessor shall be

bound to take commercially reasonable steps to assist the lessee", leaves open the possibility that the lessor's obligations could be more extensive. The text also leaves open the possibility that the lessor may have to bear the cost of making these efforts, even though it is a fundamental principle of contract law that the parties should have the freedom to allocate transaction costs as they see fit in the context of their lease arrangement.

Re: Article 9 - Limitation of liability of the lessor

We are very troubled by the insertion of the text in the comment to Article 9 which states that "In order that the future model law not conflict with existing domestic laws regarding products liability, Article 9 does not affect the lessor's liability in any other capacities, such as that of owner". If this sentence remains in the draft model law, we believe it will signal the end of the future model law as an effective tool to foster the growth of leasing. The notion that a financial lessor may be liable as owner ignores the essential characteristic of the financial lessor, which is that it is a party that is providing financing only and that it did not manufacture, market or sell the leased goods and will not have control or possession of them. It is difficult to conceive of a reason why a lessor would enter into a financial lease as a lessor if it may be liable for damages arising from the use, condition or manufacture of the leased goods, all of which are outside the financial lessor's control, when it could instead loan the money to the lessee to enable the lessee to purchase the goods and avoid the potential liability. The whole purpose of the future model law is to introduce leasing to new markets. It should surprise no-one that the existing domestic laws of such countries do not contain exceptions for, or take into account financial leases. It seems to us that, rather than defer to those existing domestic laws, the future model law ought to override such laws to the extent that they would hold a financial lessor liable under a products liability standard. We recommend that not only should the new text in the comment be deleted but that the body of Article 9 make clear that a financial lessor is not liable in its capacity of lessor or owner of the leased asset for injuries or damages caused to the lessee or third parties or their property (unless resulting from the negligent acts of the lessor).

Re: Article 16 - Warranty of quiet possession

We recommend deleting the last sentence of each of Article 16(1)(a) and Article 16(2), stating that "The parties may not derogate from or vary the effect of the provisions of this paragraph." We think this provision is unnecessary in this context. Not allowing the parties to the lease to modify the application of the quiet enjoyment warranty seems intrusive. That decision seems to imply that a lessor is in a position to assume the risk of claims of third parties and that it is more equitable for the lessor to assume this risk than the lessee. We do not believe these assumptions ought to be elevated to the status of unalterable legal mandates. Rather, the question of the scope of the quiet enjoyment warranty ought to be left to the parties to negotiate.

Failing to remove the last sentence of each of Article 16(1)(a) and Article 16(2), we suggest the following revisions:

(i) Article 16(1)(a) fails to account for sub-leases, which are permitted under the draft model law. A sub-lessor will not be able to make the quiet possession warranty to the sub-lessee, as the lessor will by definition have superior title or right to the leased asset. We assume this was an oversight and will be corrected.

(ii) We are troubled by the use of "intentional" in Article 16(1)(a). We understand the use of a negligence standard but "intentional" sweeps too broadly. We think the more appropriate standard is either wilful misconduct or bad faith.